

Engaging for a greener future

➤ **Andrew Parry explains why active managers are well placed to support the energy sector's lower carbon transition**

It is no secret that price-competitive renewables, advances in technology, changing social norms and increased regulation are colliding with economic difficulties and taking their toll on oil, gas and coal company profits. The sector's woes are such that, despite short-term bumps, as of the end of 2020, energy stocks accounted for less than 3 per cent of the S&P 500, down from over 16 per cent in 2008.

The spectre of stranded assets is also becoming more apparent, with asset impairment charges increasing across the fossil-fuel industry, and giving rise to the new concept of stranded liabilities. Specifically, this is the cost of retiring long-lived oil and gas infrastructure. Expanding production of the feedstock for plastics could prove another misallocation of capital, as changing attitudes to single-use plastics could translate into this 'growth opportunity' becoming an oversupplied or even declining market.

As a result, many fund managers are increasingly avoiding the energy sector on concerns over potential permanent capital impairment. Asset owners, however, recognise that as universal owners of the market they have a stake in encouraging a successful energy

transition to renewables. Simply put, they view it as short-sighted and misguided to eschew the industry entirely.

While some asset owners have divested from fossil fuels – recognising that rising concern for the environment is linked to poor financial returns – some continue to invest in the hope of driving change through engagement. Active managers, drawn by seemingly low valuations, are engaging alongside them, with the combined weight of their collective voices leading to better reporting and some shift in strategy towards redirecting a growing proportion of capital expenditure to renewables. The challenge remains whether the changes being supported by engagement will be sufficient to avoid fossil-fuel stocks becoming 'value traps'.

Active managers have distinct advantages – the most obvious being that, through selectivity, they have far fewer securities to cover than a passive manager. Furthermore, traditional active managers can embed engagement opportunities into their due diligence analysis of stocks before purchase. Finally, the continuous feedback loop between company management teams and active managers provides greater insight into the quality of corporate governance, a perspective that makes for better-informed decisions when it comes to proxy-voting judgements. In our view, this should make active managers more informed voters of proxies, with the ultimate sanction of selling if change is not forthcoming and client capital is at risk.

Climate risk management promises

increasingly to lead active managers to put fossil-fuel assets in a 'why bother?' bucket. For universal owners, however, achieving alignment with climate outcomes delivers different conclusions, as they are focused on managing long-term systemic risk associated with owning the market. Without the sanction of divestment, there is a danger that perpetual engagement leads to mere token action, such as committing to a 2050 net-zero carbon target, while failing to commit to absolute emission reductions and key interim milestones.

The recent and rapid growth of both active and passive environmental, social and governance (ESG) and sustainable assets has been accompanied by a rise in active engagement and proxy voting. This new-found investor activism only promises to grow as we emerge from our current Covid-19 environment. The increasing adoption of Task Force on Climate-related Financial Disclosures (TCFD) reporting, and the commitment to net-zero targets and absolute emission-reduction targets by a few companies, alongside accelerated investment in renewables, is evidence that fossil-fuel companies are responding to pressure, both economic and from shareholders.

The question remains whether the industry can remain relevant in a rapidly changing world. While denying access to capital can be a powerful force, the energy industry is inextricably interwoven with geopolitics, which is why avoidance, divestment and engagement are the sharpest arrows in the quiver for active investors as we aim towards achieving cleaner energy for tomorrow.



➤ **Written by Newton head of sustainable investment, Andrew Parry**

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